

Private Equity & Venture Capital in Asia  
Professor Claudia Zeisberger

Paper:  
**The role of government in venture capital  
development in Hong Kong**

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## Introduction

Governments around the world have been playing an important role in fostering innovation and entrepreneurship. Many important technological developments now used in commercial applications arose from government-funded research and development. The government in Hong Kong also provided the favorable type of soil for start-up businesses. In the keynote speech of the Financial Secretary Mr Anthony Leung at the Hong Kong Venture Capital Conference on 16 September 2002, he said 'Our strategic position offers significant opportunities, and venture capitalists in Hong Kong are ideally positioned to take on these opportunities. I would like to assure you that the Government commits to promote and strengthen our position as a premier international financial center of Asia, including that for venture capital and private equity.'

In this essay, I am going to reflect what I have learned during the course 'Private Equity & Venture Capital in Asia' to the real business situation in Hong Kong. I will highlight the key government initiatives, discuss and analyze the current issues, and project the future role of government in venture capital development in Hong Kong.

## History

There was not much venture capital industry before the 1990s. New businesses relied on self-funding or pooling of resources from friends and family (Angel Investing Part IV 2010). Until the late 1980s, the first venture capital company was founded. From 1990 onwards, there was a change of attitude and various reforms were made to government's policy toward technology and innovation. This, coupled with the business opportunities created by mainland China's rapid economic development, caused the subsequent growth in Hong Kong's venture capital sector. Today, Hong Kong has developed into the largest venture capital center in Asia, managing almost one-third of the total capital pool in the region.

## Key government initiatives

The Hong Kong government was mindful of the venture capital opportunities and created a number of initiatives to facilitate the growth and development of the industry.

### 1. Set up financing systems and government direct investment

#### Set up venture capital financing system

Government set up venture capital financing systems to support non-governmental VCs through:

- providing supplementary low interest government loans to non-governmental venture capital
- offering governmental guarantees to the loans non-governmental venture capital firms were getting from relevant banks

#### Government direct investment

The **Innovation and Technology Commission (ITC)** was set up in 1 July 2000 (refer Figure 1). The mission of the ITC is 'to spearhead HK's drive to become a world-class, knowledge-based economy and to coordinate the

formulation and implementation of innovation and technology policy and ensure greater synergy among different elements of the innovation and technology programme.' (HK: The Facts 2009:1-3)

The different programs done by ITC in past decade include:

**Funding Schemes:** Manages the following funding schemes to encourage HK companies to develop innovative ideas and technology business:

- The Innovation and Technology Fund (ITF) was set up in November 1999 with HK\$5 billion fund.
- The Applied Research Fund (ARF) - At the end of October 2009, the ARF made 24 investments with funding of HK\$392 million since the engagement of the fund managers.<sup>1</sup> (The list of investments by research/industry sectors is shown in Figure 2.<sup>2</sup>)
- Small Entrepreneur Research Assistance Program (SERAP)

**Technological Infrastructure:** Helps to develop world-class support infrastructure to facilitate technological upgrading and development.

- The Hong Kong Science and Technology Parks Corporation (HKSTPC) was set up in May 2001 and developed by Hong Kong Science Park
- The Hong Kong Applied Science and Technology Research Institute Company Limited (ASTRI).<sup>3</sup> The Hong Kong Jockey Club Institute of Chinese Medicine Limited (HKJCICM)
- The Hong Kong Productivity Council (HKPC)

**Human Capital:** Provides suitable human resources to the promotion of innovation and technology in Hong Kong. ITC implemented:

- New Technology Training Scheme which provides financial assistance to companies that wish to have their staff trained in a new technology
- Internship Program in 2004 which attracts promising science and engineering graduates to take part in ITF-funded R&D projects to better equip them for a future career in industrial and commercial R&D. As at the end of October 2009, a total of 381 interns have been approved.

**Technology co-operation with the Mainland:** Strives to strengthen co-operation between the Mainland and Hong Kong in innovation and technology.

- Mainland and Hong Kong Science and Technology Co-operation Committee was set up in 2004
- Guangdong/Hong Kong Technology Cooperation Funding Scheme was set up in 2004. From 2004 to 2007, the two governments supported 900 projects under the scheme with a total funding of about HK\$2 billion.

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<sup>1</sup> The Applied Research Fund (ARF) is administered by the Applied Research Council (ARC), a private company wholly owned by the Government. The ARC has appointed private sector venture capital firms to manage the investment of funds from the ARF since 1998. (HK: The Facts 2009: 1-2).

<sup>2</sup> Based on 'Fact and Figures' from ITC <http://www.itc.gov.hk/en/fact/research.htm#arc> after

<sup>3</sup> In January 2000, the Government incorporated a limited company, the Hong Kong Applied Science and Technology Research Institute Company Limited (ASTRI), under the purview of the Innovation and Technology Commission of the Commerce, Industry and Technology Bureau (CITB), to conduct research and development (R&D).

- Shenzhen/Hong Kong Innovation Circle was set up in 2007. In May 2008, its first major project was to successfully invite DuPont, a U.S. company, to set up its photovoltaic (PV) global business headquarters and R&D center in Hong Kong, and a manufacturing base in Shenzhen. DuPont's global business headquarters and R&D center in Hong Kong Science Park were opened in March 2009.

**Standards and Conformity Assessment:** Underpins the social, economical and technological development of a society. The Hong Kong Accreditation Service (HKAS) of ITC improves the standard of local conformity assessment services and supports the development of the testing and certification sector. (HK: The Facts 2009: 3)

**CreateHK** was established 1 June 2009. It is a dedicated agency set up to lead, champion and drive the development of the creative economy in Hong Kong. Two among its set of duties and responsibilities are:

- Oversee the administration and management of the Film Development Fund, the DesignSmart Initiative, the CreateSmart Initiative and other funds established to promote the development of the creative industries;
- Administer and provide financial support to special projects and programs in support of the creative industries, including the InnoCentre Incubation Programme, design incubation, and development of creative curriculum and talents (CreateHK website)

## **2. Provide legal support**

The government envisioned that legislation and supervision are guarantees for the healthy development of Hong Kong's venture capital industry. (Government's Role 2002) The Chinese central government gives top priority to the development of small and medium-sized (SME) enterprises and offers special legal protection to venture capital enterprises. Although HK sets its own venture capital laws, it is mindful of and tries to stay compatible with China's venture capital laws.

### SME Promotion Law

The Chinese central government issued several opinions on encouraging, supporting and guiding the development of non-public economic sectors such as individually-owned and private businesses, and different ministries and local government authorities have introduced preferential measures in support of SME development.

### Provisional Measures for the Administration of Venture Capital Enterprises

The National Development and Reform Commission, in conjunction with nine other government ministries and commissions, formulated the Provisional Measures for the Administration of Venture Capital Enterprises which:

- Makes way for more fund raising opportunities for R&D institutions thereby benefiting Hong Kong companies that are engaged in this kind of business activity
- Stipulates the number of investors and the investment amount of any single investor, providing the legal ground for venture capital firms to raise funds privately

- Stipulates that venture capital enterprises may invest all their assets in making external investments. Venture capital enterprises may also carry out investment in the form of quasi equity such as shareholding, preferred stock and convertible preferred stock
- Stipulates the use of favorable taxation policies (Provisional measures 2006)

### **3. Preferential taxation treatment**

Venture capital enterprises are weak in fund-raising capabilities due to their high risk and low success rate. Therefore, the government has adopted preferential taxation treatment in the form of exemptions and reductions to support the development of the venture capital industry.

#### Profits Tax Exemption for Offshore Funds

In March 2006, Hong Kong's Legislative Council passed the Revenue Bill 2005,<sup>4</sup> which includes profit tax exemptions such as:

- Helps attract new offshore funds to Hong Kong
- Encourages existing ones to continue to invest here
- Levels the competitive advantage against other major international financial centers such as New York, London, Singapore, and all tax-exempt offshore funds
- Maintains international expertise, promotes new products, and further develops the local fund management industry

#### Avoidance of Double Taxation between China and Hong Kong

The Arrangement for the Avoidance of Double Taxation on Income and Prevention of Fiscal Evasion (DTA) came into effect on 1 April 2007 which:

- Reduced tax rates on passive income such as interest payments, dividends, royalties and capital gains
- Created a favorable factor when compared with other countries with double tax treaties with China
- Strengthened Hong Kong's position as the gateway for foreign investments into Mainland China

### **Current issues**

Given the key initiatives created by the government in Hong Kong, some critics charge that much more could have been done to improve and support the venture capital industry. Critics argue that government support is essential to the development of a country's venture capital industry, and argue that the Hong Kong government has been paying too much attention to later stage companies and neglecting early stage companies, resulting in the following:

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<sup>4</sup> 'Under the proposal in the Bill, offshore funds, i.e. non-resident entities (which can be individuals, partnerships, trustees of trust estates or corporations) administering a fund, are exempt from tax in respect of profits derived from dealings in securities, dealings in futures contracts and leveraged foreign exchange trading [as defined in the Securities and Futures Ordinance (Cap. 571) (SFO)] in Hong Kong carried out by specified persons such as corporations and authorized financial institutions licensed or registered under the SFO to carry out such transactions.' (From 'Venture Capital Sector' <http://www.lowtax.net/lowtax/html/hongkong/jhkvent.html>)

## **1. Lack of governance**

Hong Kong Applied Science and Technology Research Institute (ASTRI)

The Audit Commission of HK government (Audit) has conducted a value for money audit on the administration of ASTRI.<sup>5</sup> Audit has identified six areas of issues, in total 22 items, where there is room for improvement:

- Corporate governance
- Management of conflict of interest
- Remuneration and recruitment
- Project management
- Project cost control
- Cost and achievements of ASTRI

In one of the remarks in project cost control, the Audit noted that 'ASTRI had paid fees of about \$181,000 for the engagement of fung shui consultants to advise on the relocation of office and the office environment. It is uncommon to use public funds for such a purpose.' (Report No. 48 2007: 5)

### Applied Research Fund (ARF)

After a review in end 2004, based on the latest valuation, it was found that ARF incurred a capital loss of HK\$247m, with many projects suffering a near total loss.<sup>6</sup> The government has decided that ARF should stop making new investments. The Audit has recommended that:

- Secretary for Commerce, Industry and Technology should take the lead to critically review the role of the ARF in the context of the Government's overall strategy in supporting innovation and technology development
- Applied Research Council (ARC) and the Commissioner for Innovation and Technology should take vigorous actions to strengthen control over the disposal of ARF investments and consider requiring more frequent progress reporting by fund managers (Report No. 42 2004: 2)

## **2. Offshore Funding**

Hong Kong is the largest venture capital center in Asia, having the second largest concentration of venture capital professionals in the region and managing 32% of the total capital pool in the region. Over 90% of the venture funds are sourced from overseas and then disbursed to overseas companies, based on beneficial tax treatment. Only a small proportion of this money is actually invested inside Hong Kong, which acts as a regional entrepot rather than as a destination for investment.<sup>7</sup>

## **3. Competition with other global financial centers**

Major financial centers such as New York and London as well as the other major player in the region, Singapore, all exempt offshore funds from tax.

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<sup>5</sup> ASTRI was mentioned in previous section - Key government initiatives. The detail of the audit can be found in Report No. 48 of the Director of Audit - Chapter 2 (2007) [http://www.aud.gov.hk/pdf\\_e/e48ch02\\_sum.pdf](http://www.aud.gov.hk/pdf_e/e48ch02_sum.pdf)

<sup>6</sup> The detail of the audit can be found in Report No. 42 of the Director of Audit — Chapter 2 (2004) [http://www.aud.gov.hk/pdf\\_e/e42ch02summary.pdf](http://www.aud.gov.hk/pdf_e/e42ch02summary.pdf)

<sup>7</sup> 32% was at the time of writing, taken from 'Venture Capital Sector' <http://www.lowtax.net/lowtax/html/hongkong/jhkvent.html>

Hong Kong is largely an administrative hub serving the region. However, this favorable situation seemed to come under threat in 2003 when the government planned to tighten the rules governing 'offshore' funds based in Hong Kong. The financial services industry has expressed the view that it is vital for us to provide tax exemption for offshore funds, or otherwise some of these funds may relocate away from Hong Kong, leading to loss of market liquidity and a negative read-across impact on other financial services, including downstream services such as those provided by brokers, accountants, bankers and lawyers. Indeed, Hong Kong hopes to grow this revenue stream, as evidenced by the Revenue Bill 2005.

### **Looking forward**

Government plays a vital role in maximizing venture capital's impact on a society. By understanding the effects of government's policy on venture capital, government can help ensure the health of this vital source of economic growth.

In April 2009, Chief Executive Donald Tsang announced that Hong Kong should focus on and encourage businesses in six major industrial areas including innovation and technology, the cultural and creative industry, and the environmental industry where Hong Kong is believed to have competitive advantages. To secure this competitive position, the government needs to create a sound market environment for the development of venture capital by:

1. Laying out a coordinated development and strategy plan for venture capital industry
2. Strengthen the macro guidance and governance on venture capital
3. Stimulate the industry through the provision of financing services
4. Perfect law and regulation formulation to standardize venture capital
5. Stipulate the use of favorable taxation policies on promoting the development of venture capital
6. Standardize and perfect the securities market and consolidate the supporting conditions
7. Establish information exchange channels for the start-up investment companies, high-tech enterprises, science and technology professionals, and financial institutions
8. Provide proper training to venture capital management talents  
(Government's Role 2002: 14-18)

Most importantly, HK should seize the golden opportunity of its proximity to China, which is undergoing rapid growth in its venture capital industry (Figure 3).<sup>8</sup> HK can also capitalize on its significant knowledge of economic development and its longer history in venture capital industry.

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<sup>8</sup> 'China was a clear favorite among U.S. investors with 42 percent of respondents believing that the country has the most to gain (in venture investing).' (Global trends in venture capital 2009: 15)

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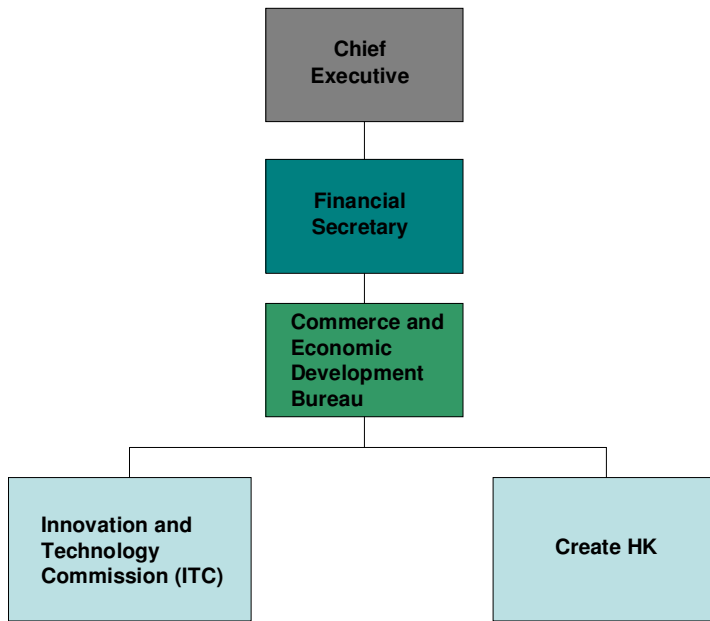


Figure 1 - Hong Kong Government Organization Chart

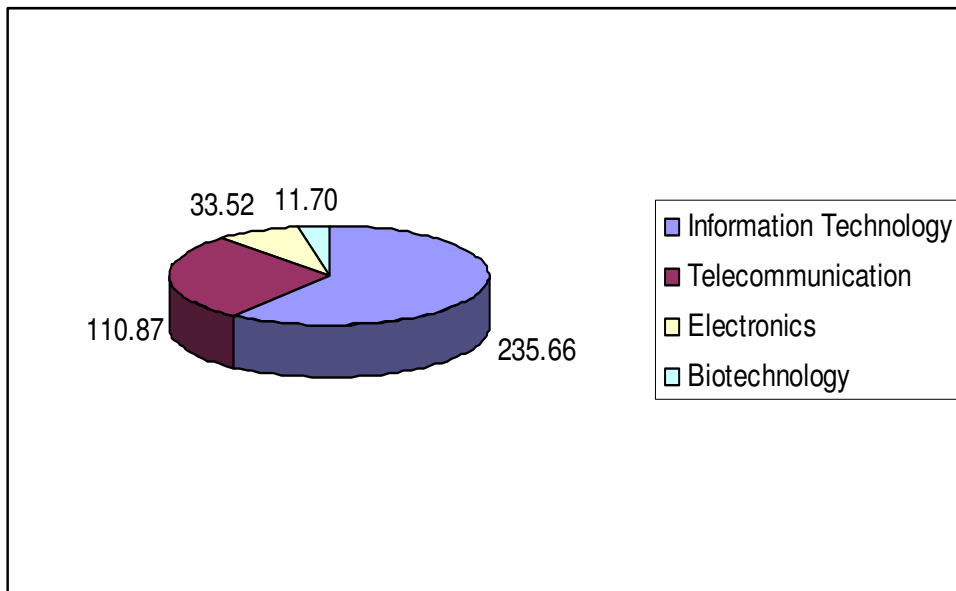
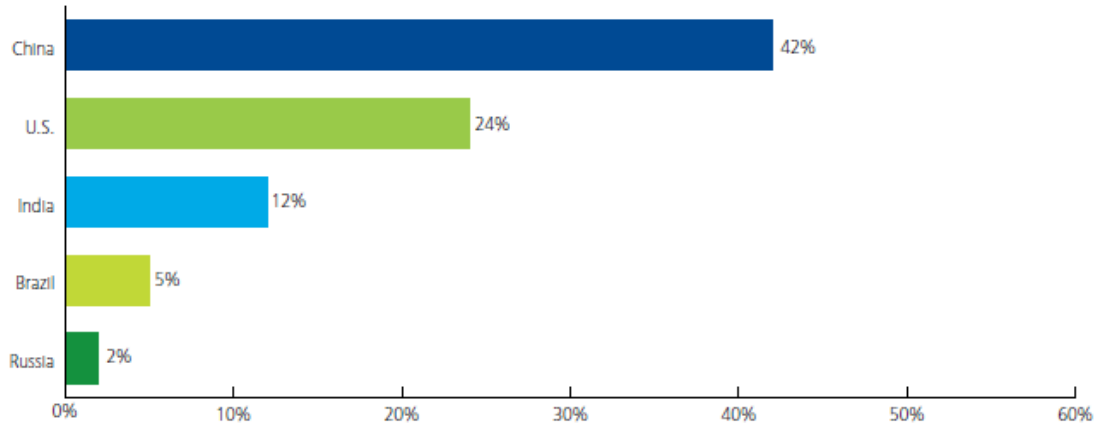


Figure 2 - List of investments (by research/industry sectors) supported by Applied Research Council, October 2009



**Figure 3 – Top five locations viewed as having the most to gain in terms of overall economic stature, over the next three years (U.S. respondents)**  
(Source: Global trends in venture capital 2009 global report, Deloitte)